CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

March 13, 2006

AGENDA ITEM 8c

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Corporate Governance Core Principles and Guidelines Revisions

II. PROGRAM: Global Equity

III. RECOMMENDATION: Amend CalPERS' Corporate Governance Core Principles and Guidelines to:

1) Add Appendix D to reflect executive compensation provisions that should be addressed when companies design executive compensation policies;
2) Add a sub-section labeled Audit Integrity and one related principle to address shareowner ratification of the independent external auditor ;
3) Add a sub-section labeled Corporate Responsibility and one related principle to address environmental disclosure;
4) Revise the sub-section labeled Shareowner Rights to reflect proxy votes cast (as opposed to total proxy votes) in the application of CalPERS' majority vote principles.

IV. ANALYSIS:

Executive Summary

Over the course of the last two years, the Investment Committee has adopted a number of corporate governance initiatives that should be incorporated into CalPERS' Corporate Governance Core Principles and Guidelines. This will enable greater clarity for staff and the marketplace in the upcoming proxy season. This agenda item seeks Committee approval to amend CalPERS' Principles in order to support proxy voting execution in the upcoming 2006 proxy voting season. Attachment 1 contains CalPERS' Principles as currently approved by the Investment Committee with the following recommended amendments (shown in red):

- (Page 17-18, Attachment 1) The addition of a new Appendix that will enhance CalPERS' position on executive compensation by providing a framework and ten specific provisions.
- (Page 8-9, Attachment 1) The addition of a new sub-section labeled Audit Integrity. Staff is recommending the addition of one related principle providing for the annual ratification of a company's independent external auditor by shareowners.
- (Page 12, Attachment 1) The addition of a new sub-section labeled Corporate Responsibility. Staff is recommending the addition of one related principle addressing the accurate and timely disclosure of environmental data to shareowners.
- (Page 12-13, Attachment 1) The revision of an existing sub-section labeled Shareowner Rights. Staff is recommending the modification of CalPERS' views on majority vote to improve clarity and reflect total proxies cast as opposed to total proxy votes.

<u>Background</u>

Staff executes all proxies and voting instructions in a manner that is consistent with the Board's Principles of Corporate Responsibility and Governance Accountability. An exception is provided when a vote may result in long-term harm to the company that outweighs all reasonably likely long-term benefit to the company (i.e., is inconsistent with the Board's fiduciary duties) or such a vote is contrary to the interests of the members and beneficiaries of CalPERS' system under the Board's fiduciary duties.

Proxy voting is highly seasonal. March through June of each year is generally considered the peak of proxy season for CalPERS. Staff votes approximately 70%[1] of all CalPERS portfolio company proxies during this time frame. When voting U.S. proxies, staff utilizes the Board's Corporate Governance Core Principles & Guidelines ("Principles").

Consistent with previous years, staff will be applying CalPERS' Principles for the proxies that come to vote this upcoming proxy season. Over the last year, the Investment Committee has approved CalPERS' corporate governance activities

[1] Staff voted 3,562 proxies out of 4,862 proxies during the months of March through June in 2005.

to reform egregious executive compensation practices, ensure audit integrity, improve environmental disclosure, and advocate majority vote election procedures.

As a result of executive compensation, audit integrity, environmental disclosure, and majority vote initiatives already approved by the Investment Committee, staff is recommending the addition of new principles to the Board's Corporate Governance Core Principles and Guidelines in order to facilitate the execution of the System's proxies for the upcoming proxy season. Attachment 2 compares staff's recommended new principles to the positions of external institutional entities considered to be thought leaders in corporate governance practices.

Amendments to Corporate Governance Core Principles and Guidelines

Executive Compensation

At its June 17, 2002 meeting, the Investment Committee approved amendments to CalPERS' Principles by adding the sub-section *C. Executive Compensation*, and content therein, under *Section III. Core Principles*. In addition, the Committee approved an amendment to *Section IV. Governance Guidelines* under sub-section *D. Shareowner Rights* to reflect that all equity based compensation plans and material changes to existing equity based plans, including stock option repricing, should be shareowner approved.

Since the June 2002 meeting, the Committee has approved model executive compensation policy guidelines (June 16, 2003), specific proxy voting applications (June 16, 2003), and a three-year strategic plan for executive compensation reform (November 15, 2004).

In this agenda item, staff is recommending amendments to CalPERS' Principles in order to enhance, and provide greater clarity around, staff's delegation to vote on related executive compensation proxy proposals for the upcoming proxy season. To accomplish this objective, staff is recommending the addition of a dedicated appendix (Appendix D of Attachment 1) for framing executive compensation provisions that should be addressed and disclosed to shareowners.

The appendix identifies the annual compensation committee report as an appropriate conduit by which to disclose a company's executive compensation policy and provides the following framework within which executive compensation provisions can be addressed:

A.) Structure and components of total compensation.
B.) Incentive and bonus compensation.
C.) Equity compensation.
D.) Utilizing and disclosing performance criteria.
E.) Use and disclosure of severance agreements.
F.) Use of "other" forms of compensation.
G.) Use of retirement plans.

In addition to the proposed framework, staff is recommending ten specific provisions that will enhance CalPERS' existing position on executive compensation to advocate for the proper alignment of executive compensation practices with shareowner interests.

As approved by the Investment Committee on June 13, 2003, CalPERS believes executive compensation policies should contain, at a minimum, the company's intended forms of incentive and bonus compensation, including the measures used to drive incentive compensation.

The specific metrics the company will use in constructing performance-based components should be established prior to any compensation period. Publicly disclosing financially measurable performance objectives will ensure accountability of the company's executives to shareowners. In addition, the rationale for any amendment to pre-established performance objectives should be disclosed with justification describing how the amendment benefits shareowners. Staff has addressed the right of shareowners to see financially measurable performance objectives as well as the provisions by which companies amend pre-established performance objectives by recommending B.1 and B.2 described below.

On February 14, 2006, the Committee directed staff to amend its principles to provide for the development and disclosure of "clawback" provisions in order to recoup merit-based compensation awarded on the basis of misstated or fraudulent company performance. Staff has addressed this direction by recommending the addition of provision B.3 described below.

Additional incentive or bonus executive compensation that coincides with the sale or purchase of substantial company assets can be significant and, in some instances, detrimental to long-term shareowner value creation, while affording company executives egregious short-term compensation windfalls. Therefore, staff is recommending the addition of provision B.4 to hold compensation committees accountable for protecting long-term shareowner interests when awarding excess executive compensation in the event of a substantial company asset sale or purchase.

Staff is recommending the following four specific provisions related to incentive and bonus compensation:

B.1. – Incentive and bonus compensation: *Specific performance objectives should be set before the start of a compensation period. Previous years' objectives which triggered incentive payouts should be disclosed.*
B.2. – Incentive and bonus compensation: *Provisions for the resetting of performance hurdles in the event that incentive grants are retested[2] should be disclosed.*
B.3. – Incentive and bonus compensation: *Companies should develop and disclose a policy for recapturing bonus and incentive payments that were made to executives on the basis of having met or exceeded performance targets during a period of fraudulent activity or a material negative restatement of financial results for which executives are found personally responsible.*
B.4. – Incentive and bonus compensation: *A process should be disclosed by which additional compensation for executives, that coincides with the sale or purchase of substantial company assets, can be ratified by shareowners.*

As approved by the Investment Committee on June 13, 2003, CalPERS believes executive compensation policies should contain, at a minimum, the company's intended distribution of equity-based compensation and philosophy relating to the dilution of existing equity owners. Staff is recommending two new provisions (C.1 and C.2) and one revision (C.3) to an existing Board approved proxy voting principle.

Equity compensation plans should not be designed to solely pay off executive short-term decisions pertaining to mergers, acquisitions, or other change-in-control events. Long-term shareowners require assurances that their interests will be protected in the event of such executive decisions. Therefore, staff is recommending the addition of provision C.1. Companies should also develop and disclose a policy for recapturing dividend equivalent dividends paid on unvested equity that were made to executives in the event that unvested equity ultimately never vests. Therefore, staff is recommending the addition of provision C.2.

CalPERS withheld its vote from a majority of the equity compensation plans brought before shareowners for approval last year as a result of CalPERS' proxy voting applications related to equity compensation plans. The Board's existing proxy voting principle related to vesting periods states that CalPERS will vote against any plan that does not include vesting periods of at least four years for a significant portion of overall grants.

[2] "Retested" means extending a performance period to enable initial targets to be achieved.

Many of the equity compensation plans staff voted on in 2005 demonstrated CalPERS' objectives to improve disclosure and move the market toward more performance-based pay models. However, staff withheld CalPERS' vote from improved equity compensation plans with a three year vesting period because of the Board's proxy voting requirement of a four year vesting period. Staff believes that revising CalPERS guideline on equity vesting from four years to three will enable CalPERS to endorse positive change in many compensation plans without compromising the overall equity vesting objectives.

Staff is recommending the following three specific provisions related to equity compensation:

> ***C.1. – Equity compensation:*** *In the event of a merger, acquisition, or change in control, unvested equity should not accelerate but should instead convert into the equity of the newly formed company.*
> ***C.2. – Equity compensation:*** *Distribution of dividend equivalent dividends on unvested equity should be prohibited unless a provision exists that would recoup payouts made on unvested equity.*
> ***C.3. – Equity compensation:*** *Equity grants should vest over a period of at least three years.*

As approved by the Investment Committee on June 13, 2003, CalPERS believes executive compensation policies should contain, at a minimum, the specific criteria the company will use in constructing the performance-based components of the plan. Time accelerated vesting is not considered a meaningful performance-based hurdle. Therefore, staff is recommending the following specific provision related to utilizing and disclosing performance criteria:

> ***D.1. – Utilizing and disclosing performance criteria:*** *The use of time vested equity, which supercedes any other performance metric, as the sole component to construct performance-based compensation plans, is not an appropriate pay-for-performance model.*

As approved by the Investment Committee on June 13, 2003, CalPERS believes executive compensation policies should contain, at a minimum, the parameters by which the company will use severance packages, if at all. Severance agreements can result in the destruction of long-term shareowner value. Therefore, staff is recommending the following specific provision related to the use and disclosure of severance agreements:

E.1. – Use and disclosure of severance agreements: *Severance agreements[3] that provide benefits[4] with a total present value exceeding market standards[5] should be ratified by shareowners.*

As approved by the Investment Committee on June 13, 2003, CalPERS believes executive compensation policies should be transparent to shareowners. Defined contribution and defined benefit retirement plans can be a significant component of executive compensation. Therefore, staff is recommending the following specific provision related to the use of retirement plans as a component of total compensation:

G.1. – Use of retirement plans: *Defined contribution and defined benefit retirement plans should be clearly disclosed in tabular format showing all benefits available whether from qualified or non-qualified plans and net of any offsets.*

Audit Integrity

The International Corporate Governance Network ("ICGN") revised its Statement on Global Corporate Governance Principles on July 8, 2005, to reflect the development of the highest quality internal accounting and financial reporting standards, while also supporting the global harmonization of comparable standards.

The new ICGN Audit Principles state that the annual audit of the financial statements carried out on behalf of shareholders should be required for all corporations. Further, the audit should be carried out by independent, external auditors who should be proposed by, or with the assistance of the audit committee of the board, for approval by the shareholders.

CalPERS has taken action through its Governance Program to support reform related to the independence of external audit firms in the U.S. A primary focus of CalPERS' efforts has been on regulatory reform, ultimately including the role of the newly formed Public Company Accounting Oversight Board (PCAOB). The Sarbanes-Oxley Act gives the PCAOB clear direction to consider additional rules beyond the original provisions of the Act in regard to audit independence.

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[3] Severance agreement means any agreement that dictates what an executive will be compensated when the company terminates employment without cause or when there is a termination of employment following a finally approved and implemented change in control.
[4] Severance benefits mean the value of all cash and non-cash benefits, including, but not limited to, the following: (i) cash benefits; (ii) perquisites; (iii) consulting fees; (iv) equity and the accelerated vesting of equity, (v) the value of "gross-up" payments; and (vi) the value of additional service credit or other special additional benefits under the company's retirement system. Severance benefits do not include already accrued pension benefits.
[5] The disclosed threshold in the United States should not exceed 2.99 times the sum of the executive's base salary plus target bonus which is consistent with IRS standards as of January 1, 2006.

Staff is recommending the addition of a dedicated sub-section of CalPERS' Principles and the inclusion of one principle that supports shareowner proposals that recommend the selection of a company's independent external auditor be ratified by shareowners. The addition to CalPERS' principles would be as follows:

Audit Integrity

The company should support the development of accurate audited financial statements. CalPERS believes annual audits of financial statements should be required for all companies and carried out by an independent external auditor. This audit should provide and objective opinion that the financial statements present fairly, in all material respects, the financial position of the company in conformity with applicable laws, regulations and standards.

1. The selection of the independent external auditor should be ratified by shareowners annually.

Corporate Citizenship & Ethical Conduct

On February 14, 2005, the Investment Committee approved CalPERS' Corporate Governance Environmental Strategy to facilitate the improvement of disclosure on green house gas emissions and timely reporting of environmental data by portfolio companies. CalPERS believes that it is the responsibility of companies to provide meaningful, consistent, and robust reporting of environmental practices, risks, and potential liabilities. Improved data transparency could help long-term risk assessment at the companies in which CalPERS invests.

Staff is recommending the addition of a dedicated subsection of CalPERS' Principles to corporate responsibility and the inclusion of one principle that supports staff's ability to vote in favor of future shareowner proposals supporting accurate and timely disclosure of environmental risks, such as those associated with climate change. The addition to CalPERS' Principles would be as follows:

Corporate Responsibility

Companies are expected to conduct themselves with propriety and with a view toward responsible corporate conduct. A level of performance above minimum adherence to the law is generally expected.

CalPERS believes that it is the responsibility of companies to provide meaningful, consistent, and robust reporting of environmental practices, risks, and potential liabilities. With adequate, accurate and timely data disclosure, shareowners are *able to more effectively make investment decisions by taking into account the environmental practices of the companies in which the Fund invests.*

1.	***To ensure sustainable long-term returns, companies should provide accurate and timely disclosure of environmental risks, such as those associated with climate change.***

Shareowner Rights

CalPERS' majority vote principles, as applied to a shareowner's ability to amend company bylaws and elect directors, are currently addressed in the Shareowner Rights sub-section of CalPERS' Principles. However, as currently written, CalPERS' majority vote principles reflect total proxy votes as opposed to votes cast in the application of principles such as a shareowner's right to amend company bylaws or elect directors.

Therefore, staff recommends CalPERS' majority vote principles be amended and read as follows:

1. ***Shareowner Rights (1):*** *A majority of proxies cast should be able to amend the company's bylaws by shareowner proposal.*
2. ***Shareowner Rights (12):*** *In an uncontested director election, a majority of proxies cast should be required to elect a director. In a contested election, a plurality of proxies cast should be required to elect a director.*

Next Steps

Upon approval by the Investment Committee, staff will amend CalPERS' Corporate Governance Core Principles and Guidelines to reflect the following:

- Add Appendix D reflecting executive compensation provisions that should be addressed when companies design executive compensation policies.
- Add a sub-section labeled Audit Integrity and one related principle that addresses shareowner ratification of the independent external auditor.
- Add a sub-section labeled Corporate Responsibility and one related principle that addresses environmental disclosure.
- Revise the sub-section labeled Shareowner Rights to reflect proxy votes cast in the application of CalPERS' majority vote principles.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal I, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems.

VI. RESULTS/COSTS:

Costs associated with this item are expected to be minimal and can be absorbed within the Investment Office Budget.

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William Sherwood-McGrew
Portfolio Manager
Corporate Governance

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Dennis A. Johnson
Senior Portfolio Manager
Corporate Governance

____
Christianna Wood
Senior Investment Officer
Global Equity

____
Anne Stausboll
Interim Chief Investment Officer